


## Memorandum

To: Honorable John Chiang, Chairman  
Honorable Claude Parrish, Vice Chairman  
Ms. Betty T. Yee, Acting Board Member  
Honorable Bill Leonard  
Honorable Steve Westly, Controller

Date: April 1, 2005

From: Kristine Cazadd  
Chief Counsel 

Subject: **Petition for Amendment of Property Tax Rule 462.180 Change  
in Ownership – Legal Entities  
Chief Counsel Matters – Tuesday, April 12, 2005**

### **Background**

By letter dated January 28, 2005, Mr. Sean Flavin petitioned the Board, pursuant to Government Code section 11340.6, for amendment of Property Tax Rule 462.180, subsection (d)(2). The petition requests that subsection (d)(2) be amended to add, as a type of transfer that is not counted or cumulated to determine a change in ownership, any transfers of “original co-owners” interests between parents and children and from grandparents to grandchildren, if those transfers are effected in the manner authorized in an uncodified section of Revenue and Taxation Code section 63.1.

Under Government Code section 11340.7, the Board has 30 days from receipt to deny the petition in whole or in part, indicating the reasons why, or to initiate the rulemaking process. Mr. Flavin agreed to waive the 30-day time limit and the petition is scheduled for consideration by the Board at its meeting on Tuesday, April 12, 2005 on the Chief Counsel Matters Agenda. On April 12, the Board may (1) deny the petition; (2) grant the petition in part or in whole and commence the official rulemaking process by ordering publication of the notice pursuant to Government Code section 11346.5; or (3) request that the Property Tax Committee direct staff to commence an interested parties process to consider the requested amendment in whole or in part.

### **Summary of Staff Recommendation**

Staff recommends that the Board deny the petition because the proposed amendment conflicts with applicable constitutional and statutory law and a published appellate court decision interpreting that law. The constitutional and statutory provisions for excluding transfers between parents and children and from grandparents to grandchildren from change in ownership applies only to transfers of real property interests. The “original co-owners” interests, which Mr. Flavin proposes for exclusion, are ownership interests in a legal entity that owns real property, not real property interests. Furthermore, Mr. Flavin relies on an uncodified section of Revenue and

Taxation Code section 63.1, the statutory provision for excluding such transfers, but that uncodified section provides no support for his position.

### **Discussion of the Petition**

The petition requests that the Board amend subsection (d)(2) of Rule 462.180, *Change in Ownership – Legal Entities*. This subsection, interprets and implements Revenue and Taxation Code<sup>1</sup> section 62, subdivision (a)(2) by providing that a transfer of real property by individuals to a legal entity in which those individuals obtain ownership interests is excluded from change in ownership if the transfer results in a change in the method of holding title while the proportional ownership interests of the transferors and transferees remains the same. To illustrate, A and B each own a 50 percent interest in Property X as tenants in common, and they transfer their interests to a general partnership in which they become partners with each owning a 50 percent partnership interest. As a result, their method of holding title changes from tenancy in common ownership of Property X to partners in a partnership that owns Property X. However, the transfer is excluded because their proportional ownership interests of 50 percent each remains the same.

As a consequence of such a transfer, the transferees become “original co-owners” in the legal entity with respect to the property excluded from change in ownership. Subsequent transfers of those “original co-owners” interests are counted and cumulated and a transfer or transfers totaling more than 50 percent of those interests results in a change in ownership of the property that was previously excluded under subsection (d)(2). Thus, if A transferred 30 percent of her partnership interest to C and B transferred 25 percent of his partnership interest to D, those transfers would result in a change in ownership and reappraisal of Property X.

However, the second paragraph of subsection (d)(2) of Rule 462.180 further provides that transfers of certain “original co-owners” interests are not cumulated or counted for purposes of the 50 percent threshold. Transfers that are not cumulated or counted are “interspousal transfers excluded under Section 63 of the Revenue and Taxation Code, transfers into qualifying trusts excluded under Section 62(d) of the Revenue and Taxation Code, and proportional transfers excluded under Section 62(a)(2) of the Revenue and Taxation Code.” Those specific types of transfers are not cumulated or counted because specific regulatory provisions exclude such transfers of ownership interests for purposes of change in ownership. With respect to interspousal transfers, Rule 462.220, the regulation that interprets and implements section 63, provides in subsection (c) that changes in ownership shall not include “[t]ransfers of ownership interests in legal entities by ‘original coowners’ which would otherwise be cumulated or counted for purposes of Section 64(d) of the Revenue and Taxation Code.” Likewise, transfers of ownership interests into trusts are excluded pursuant to Rule 462.160, the regulation that interprets and implements section 62(d), and transfers of proportional ownership interests are excluded pursuant to Rule 462.180, subsection (d)(4), the regulatory provision that interprets and implements section 62(a)(2).

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<sup>1</sup> All section references, hereinafter, are to the Revenue and Taxation Code.

Mr. Flavin proposes an amendment to the second paragraph of subsection (d)(2) to add “parent-child and grandparent-grandchild transfers excluded under Section 63.1 of the Revenue and Taxation Code (provided such transfers are effected in the manner authorized in Section 2 of 1987 California Statutes, Chapter 48)”. Generally, section 63.1 provides for exclusion from change in ownership for the transfer of a principal residence and \$1,000,000 of the full cash value of other real property between parents and children and from grandparents to grandchildren, under specified conditions. Section 2 of 1987 California Statutes, Chapter 48 is an uncodified part of section 63.1 designated as a Note (“Note”), which provides that the step transaction doctrine may not be applied to a series of transfers between individuals and legal entities that are taken in order to effect a transfer of property interests that are excluded by section 63.1. The step transaction doctrine is a legal principle that states that when a transaction involves extra steps taken solely for the purpose of avoiding taxation, the form of the transaction, i.e. the extra steps, will be ignored and the law will be applied to the substance of the transaction. The Note states that, as an expression of the Legislature’s intent, the step transaction doctrine shall not apply when extra steps are taken in order to exclude certain transfers from change in ownership pursuant to section 63.1. The Note presents the following transaction: Parents hold ownership interests in a legal entity, such as a family limited partnership, which owns real property. The family limited partnership distributes real property interests to the parents but the transfer is excluded from change in ownership by Revenue and Taxation Code section 62, subdivision (a)(2) as a proportional interest transfer. The parents then transfer real property interests to their children and those transfers are excluded from change in ownership by section 63.1 which applies only to transfers of real property interests and not transfers of ownership interests in legal entities. The parents and children then transfer their real property interests back into the family limited partnership and those transfers are excluded from change in ownership by section 62, subdivision (a)(2).

Mr. Flavin states that his proposal is necessary to create parity in the treatment of transfers of real property interests in family trusts and transfers of interests in legal entities, such as family limited partnerships and limited liability companies. He explains that both forms of property ownership are used for family estate planning but that Rule 462.180, subdivision (d)(2) “inhibits the use of such [legal] entities because the passage of ownership between generations may precipitate an onerous property tax reassessment.” He further states that there does not appear to be any public policy reason for treating transfers of property interests held in trust differently than transfers of ownership interests in legal entities. He concludes that transfers of ownership interests between parents and children and from grandparents to grandchildren should be excluded because, in his view, the Note already provides that “transfers of interests in legal entities may qualify for the exclusion, if the necessary steps are followed.”

As we understand Mr. Flavin’s proposal, any transfers of “original co-owners” interests between parents and children or from grandparents to grandchildren would not be cumulated or counted if the parties could have avoided a change in ownership by following the steps described in the Note. Thus, if parents are original co-owners in their limited partnership and transfer partnership interests to their children, those transfers would not be counted or cumulated toward the 50 percent threshold.

**Staff Recommendation**

Staff recommends that the Board deny Mr. Flavin's petition because it is contrary to the plain language and intent of the constitutional and statutory provisions. Article XIII A, section 2(h) is the constitutional provision excluding from change in ownership specified transfers between parents and children. Article XIII A, section 2(h) was added in 1986 by passage of Proposition 58. In the voter pamphlet, the Legislative Analyst explained that Proposition 58 would "broaden the circumstances under which reassessment is not required in cases involving the transfer of real property between parents and children." (Ballot Pamp. analysis of Prop. 58 by Legis. Analyst as presented to the voters, Gen. Elec. (Nov. 4, 1986).) The arguments in favor of the proposition noted that it would "protect property transfers within the family." The language of the proposition, the summary and arguments referred only to transfers of real property among parents and children.

Revenue and Taxation Code section 63.1 clearly provides for a change in ownership exclusion for transfers of real property interests which are limited to transfers of a principal residence and \$1 million dollars of the full cash value of other real property. Subdivision (c)(8) defines "real property" as "real property as defined in Section 104. Real property does not include any interest in a legal entity." In *Penner v. County of Santa Barbara* (1995) 37 Cal.App.4th 1672 the court of appeal held that section 63.1 must be construed according to its plain language which provides for exclusion from change in ownership only for transfers of real property between parents and children. Thus, there is no provision for exclusion of transfers of legal entity ownership interests, such as partnership interests, between parents and children or from grandparents to grandchildren.

Mr. Flavin's proposed amendment would treat transfers of "original co-owners'" interests as though the parties had taken the steps described in the Note to section 63.1 and accomplished the same end result. However, the court of appeal in *Penner* rejected such an interpretation of section 63.1. In that case, the taxpayer argued that the step transaction doctrine allowed her to take additional steps, in accordance with the Note, that would have avoided a change in ownership but would have accomplished the same end result. Thus, she reasoned that the court should pretend that she had taken the additional steps. The court held that the step transaction doctrine was not applicable because the doctrine does not allow a taxpayer to invent steps that never existed. Instead, a transaction is to be given its tax effect in accord with what actually occurred and not in accord with what might have occurred. The court concluded that the tax consequences of transaction are determined by the steps actually taken and a taxpayer "may not enjoy the benefit of some other route [she] might have chosen to follow but did not." *Id.* at 1679 (citing *Commissioner v. Nat. Alfalfa Dehydrating* (1974) 417 U.S. 134, 149.).

Additionally, the exception to the step transaction doctrine set forth in the Note to section 63.1 clearly demonstrates that the Legislature recognized that section 63.1 excludes from change in ownership only transfers of real property interests. The express purpose of the Note is to allow an eligible transferor to exclude from change in ownership a transfer of real property interests to

an eligible transferee. Thus, the steps described in the Note effect a distribution of real property interests from a legal entity to the eligible transferor, such as a parent, so that the eligible transferor can then transfer the real property interests to the eligible transferee, a child, and that transfer will be excluded from change in ownership. If the Legislature had contemplated that section 63.1 would also exclude transfers of ownership interests in legal entities, there would be no need for the steps described in the Note.

Finally, we address Mr. Flavin's assertion that the amendment is necessary in order to create parity in the treatment of transfers of real property interests in family trusts and transfers of interests in legal entities, such as family limited partnerships and limited liability companies. Rather than creating parity, however, the proposed amendment would effectively remove the existing \$1 million dollar limit on the full cash value of transferred real property, other than a principal residence, subject to exclusion under section 63.1. For example, if a parent transfers real property, which is not a primary residence, with a full cash value of \$5 million to his irrevocable trust naming his three children as the present beneficiaries, only \$1 million of the full cash value is excluded from change in ownership pursuant to section 63.1. Thus, the transfer would result in a change in ownership of the other \$4 million in full cash value of the property. Under the proposed amendment, the parent could transfer the same property with a full cash value of \$5 million to his wholly-owned limited liability company. The transfer from parent to the limited liability company would not result in a change in ownership but the parent would become an "original co-owner". Thereafter, parent could transfer 100 percent of the membership interests in the limited liability company in equal shares to his three children. As a result, the children would indirectly own the entire property with a full cash value of \$5 million and the transfer to the limited liability company would, thereby, have avoided a change in ownership of any portion of the property. Thus, the proposed amendment would effectively remove the \$1 million exclusion limit on transfers between parents and children and from grandparents to grandchildren.

If you need more information or have questions on these issues, please contact Acting Assistant Chief Counsel Lou Ambrose at (916) 445-5580.

#### Attachments

KEC:eb

Prop/Rules/Rule 462.180/05/Amendment.doc

cc: Mr. Ramon Hirsig, MIC: 73  
Mr. David Gau, MIC: 63  
Mr. Lou Ambrose, MIC: 82  
Mr. Dean Kinnee, MIC: 64  
Mr. Todd Gilman, MIC: 70